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MEMORANDUM FOR THE RECORD

SUBJECT: "Major Industrial Countries: Positions on Restricting Credit to the Soviet Union" [redacted] 25X1

The attached paper was passed to [redacted] (ANIO/USSR-EE) on 20 April. The paper is part of a longer study requested by Under Secretary of State James Buckley in support of his discussions with the West Europeans on the subject. [redacted] 25X1 25X1

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Major Industrial Countries: Positions on Restricting Credit to the Soviet Union

All the major industrial countries -- Japan, West Germany, France, United Kingdom, Italy, and Canada -- view credit as an integral part of East-West trade, and all use official guarantees of some sort as part of their trade credit systems. None of them are enthusiastic about credit restrictions, with trade-related ministries most strongly opposed to restrictions. Any decision to restrict credit would have to be made at the highest political level. Specific credit arrangements and arguments used to justify them vary from country to country and are examined below. [redacted] 25X1

Japan

Current Situation

In recent years Tokyo has begun to move away from the idea that expanded relations with the Soviet Union would give Moscow a greater stake in stable, peaceful, bilateral relations. This change in policy is partly an effort to keep in step with the increasingly restrictive US attitude toward East-West trade and partly a reaction to events in Asia. Tokyo's freedom to overlook the political and military ramifications of trade with the USSR has declined as the buildup of Soviet strength in the Far East and the diversion of some US forces to the Indian Ocean have led them to recognize added military and political responsibilities in northeast Asia. The shift in Tokyo's policy was epitomized by the imposition of relatively strong economic sanctions after the Soviet invasion of Afghanistan. [redacted] 25X1

Changing perceptions of the profitability of Siberian development projects also have encouraged the shift in attitudes toward trade. In the late 1960s and early 1970s high Japanese growth rates and steadily expanding demand for raw materials stilled any doubts about the availability of markets for Siberian resources five or ten years in the future. Since the oil crisis of 1973/74, however, demand for commodities imported from the USSR has become much more erratic, while Japan's transformation from raw-material intensive heavy industries to technology-intensive industries is diminishing the need for new sources of many raw materials. [redacted] 25X1

As the prospects for Siberian development dwindle, so does the size of the business lobby that favors trade with the Soviet Union. Today, the primary constituencies pushing trade with the USSR are the steel and machinery industries, which account for over 70 percent of all Japanese exports to the Soviet Union, and the trading companies that act as their intermediaries in dealings with Moscow. Steel and machinery exporters consider the

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availability of official export credits essential to their ability to compete successfully against West European companies for Soviet orders; they actively pressure the government to adopt a favorable export credit policy, and their lobbying forced Tokyo to limit its post-Afghanistan sanctions to "new" credits. [redacted] 25X1

Tokyo's support for exports to the USSR takes two forms: (a) medium- and long-term trade financing extended by the Japan Export-Import Bank, and (b) a fairly standard and generally self-financing export insurance system provided through the Ministry of International Trade and Industry (MITI). The Export-Import Bank presently provides up to 70 percent of the financed portion of a transaction, but a shortage of funds this year may force a reduction to 60 percent. A down payment of 15 percent or more of the total price is required. The subsidy element in loans extended to the Soviet Union at the present OECD guideline rate of 9 percent depends on the size of the risk premium associated with the transaction. Japan's long-term prime rate is now only 8.4 percent, so the premium would have to exceed 0.6 percent before any subsidy occurred. The premium on commercial loans extended under present conditions of Soviet foreign exchange shortages and substantial political uncertainty would surely be larger, but under more normal circumstances the risk premium might be small enough to eliminate the subsidy element entirely. [redacted] 25X1

<u>Prospects</u>

Steel and machinery exporters are almost certain to strenuously oppose proposals to reduce official credits and guarantees on exports to the USSR. If, however, it becomes apparent that West European governments will consent to similar cutbacks, Tokyo will probably go along, for at least two reasons. First, Export-Import Bank funds for financing plant exports are becoming insufficient to meet demand. From this perspective, the elimination of the Soviet Union as a recipient would free funds for projects elsewhere. Second, because Japanese commercial interest rates are far below those in Western Europe or the United States, Japanese firms big and bold enough to bear the risks of exporting plants and machinery on a strictly commercial basis would be in a good position to expand their business with the Soviets. [redacted] 25X1

The gap between Japanese and West European interest rates is a potential sticking point that could greatly complicate efforts to secure Japanese and West European assent to quantitative restrictions on export credits and guarantees. The gap may alarm West Europeans and lead them to demand some type of restraint by the Japanese. Any restraints would, in turn, provoke the opposition of Japanese exporters and make it harder for Tokyo to agree to a gradual phase-out of credits and guarantees. Moreover, the export credit application process is the only lever that Tokyo now has to influence the transactions of exporters shipping items not included on the COCOM list. The Ministry of

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Finance could informally advise commercial banks to limit financing for exports to the USSR, but this would run counter to the current trend toward internationalization of the yen and liberalization of capital markets. 25X1

One solution that might be acceptable to Japan is a differentiation between yen and dollar-based credits. For credits denominated in dollars Japan would apply the same interest rate as that of other Western nations. In the case of a yen-denominated credit, the USSR would have to accept the risk of yen appreciation (or high prices once the yen has appreciated) in exchange for low interest rates. 25X1

West Germany

Current Situation

Bonn's basic position is well known: East-West trade is no different from other trade and is carried out primarily because it is economically beneficial to both sides. Supplementing this is the view that developing economic ties with the East will contribute to reducing political tensions. A third rationale is the long tradition of economic relationships with Eastern Europe (Mannesmann, for example, has been a major supplier of pipe to Moscow since 1896). Finally, in the background is the hope that improved relations will ultimately lead to German reunification. 25X1

These views have not been substantially affected by the rather sharp decline in the share of West German exports going to the USSR and Eastern Europe: from a peak of 7.2 percent in 1975 to 4.3 percent last year (excluding trade with East Germany -- 1.5 percent of total West German exports in 1981). Despite the declining share, trade with the East Bloc remains extremely important for certain depressed industrial sectors, particularly for the steel industry and for the large AEG firm, whose survival could hinge on its contract to supply compressors for the Soviet gas pipeline. 25X1

Bonn intervenes in the market to promote exports less than most other Allies. Subsidized export credits, for example, are relatively small and go primarily to LDCs. Indeed, West Germany's major trade promotion device -- export credit (Hermes) guarantees -- is at most an indirect subsidy. In recent years Hermes guarantees have covered 8-10 percent of exports; guarantees outstanding total around $60 billion, of which about $9 billion is owed by the East Bloc. 25X1

Export credit guarantees are provided by the private Hermes company operating as Bonn's agent; it thus is the government that sets policy and bears the ultimate risk. It is up to the individual West German exporter or bank to request Hermes coverage, depending on the perception of risk; exports to Western industrial countries are almost never insured. The fee structure

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is based only on the amount of the export credit, its maturity, and whether the importer is a public or a private entity -- not on the country involved. Taking a five-year credit as an example, the fee is slightly over two percent in the case of a state purchaser, almost double that for a private entity. The maximum maturity allowed is ten years for LDCs and eight and one-half years for Communist countries. Repayments must be made in equal semi-annual installments with no grace period. The system appears to operate in a non-discriminatory fashion, although guarantees for East Bloc exports always benefit from the lower fee because the importer is, by definition, a state entity. 25X1

There is no disagreement over the fact that Bonn's credit guarantees boost West German exports, but whether they constitute an export subsidy is a much more difficult question. Bonn of course believes there is no subsidy and points out that over the years the fees collected have more than covered the claims that had to be paid. The IMF and the Royal Institute of International Affairs have characterized the Hermes system as being somewhat less generous than the guarantee programs of other major Western exporters such as France, Italy, the United Kingdom, and Japan. 25X1

Prospects

There is generally little sympathy in West Germany for the use of economic weapons against the Soviet Bloc. The main exception is some elements of the opposition Christian Democrats who are inclined to take a harder line toward the USSR. The other key groups -- including the governing parties and most of the press, business, and labor -- remain firmly opposed. 25X1

West German negotiators would be most receptive to arguments for tighter credit policies if they were couched in economic terms; i.e., emphasizing the increased risk involved in loans to the Bloc. That West German markets perceive such an increase in risk seems clear both from the increased demand for Hermes guarantees and from the stagnation in private bank lending. Eastern Europe's share of West German bank loans outstanding has dropped substantially. Moreover, Bonn has stopped issuing Hermes guarantees for Poland and Romania and has stated its willingness to join in raising interest rates and reducing maturities on East Bloc credits; it will be reluctant to go any further. 25X1

Under the Hermes system tighter restrictions can be imposed for higher risk countries. Although the fees do not change, Bonn can set ceilings for the guarantees, require larger down payments, and/or reduce the percentage of the loan that is guaranteed. Bonn likely will point out that it has made large guarantees only for Poland and the USSR, and that Poland has already been cut off. Further, West German officials will argue that the USSR remains an excellent long-term credit risk, primarily because of its expected gas exports. 25X1

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Although the existence of various mechanisms within Hermes provides a potential channel for accommodating US wishes, any action by Bonn will be contingent on at least two other conditions:

- Restrictions must not impede the gas pipeline; and
- Other major Western countries must first reduce or eliminate their direct subsidies -- particularly in terms of preferential interest rates.

The second condition could be a major obstacle to tighter restrictions. Other countries seem reluctant to go as far as Bonn on credit terms; moreover, Bonn is convinced that West Germany has been the most scrupulous in terms of not subsidizing exports and of adhering to minimum interest rate agreements -- and as a result has been somewhat disadvantaged in its Eastern trade. 25X1

France

Current Situation

Since President de Gaulle began seeking a "special relationship" with the East Bloc in the 1960s, East-West trade has played a key role in French relations with the East. Trade is viewed both as having intrinsic value and as providing a means to attain broader political goals, such as demonstrating French independence and establishing France as a go-between in East-West communications. This view has not changed despite the relatively low level of Franco-Soviet trade. Last year, exports represented only 1.8 percent -- $1.6 billion -- of the value of total French exports and 2.8 percent -- $2.9 billion -- of total French imports. Energy accounted for more than 80 percent of the value of French imports. Food and agricultural products comprised the bulk of exports, followed by metals, machinery and transport equipment, and chemicals. The bilateral balance should improve slightly for France next year as some of the $800 million worth of contracts signed in 1980 are reflected in the trade figures. In addition, 1981 was an even better year for new contracts -- $1.2 billion worth were signed of which $800 million were directly related to the Yamal pipeline. 25X1

Economic relations between France and the Soviet Union are governed by long-term cooperation accords that set general guidelines for trade patterns from which specific scientific, technical, and economic agreements may be worked out. Both countries also meet periodically at "Grande" and "Petite Commissions" to discuss economic, commercial, technical, and scientific cooperation. The signing of major industrial contracts and agreement on financial terms usually have been left to periodic summits between French and Soviet leaders. Franco-Soviet trade is also promoted by international trade fairs and by firms set up in France with the participation of Soviet foreign trade organizationss. 25X1

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France's export credit system offers a comprehensive range of financing and insurance. The official export bank, Banque Francaise du Commerce Exterieure (BFCE), refinances export-related credits extended by French banks or French branches of foreign banks and lends official export credits. Insurance coverage for export credits is provided by the semiofficial export and credit insurance agency Compagnie Francaise d'Assurance pour le Commerce Exterieur (COFACE). Paris reports Soviet debt on official credits and guarantees totaled $2.3 billion at yearend 1981 and that the total stock of commitments was $4.3 billion. In addition, all export credits of at least 18 months are subsidized by the French Government for the full term of the loan at fixed rates below market costs. France is estimated to provide annual subsidies on Soviet trade of $150-$200 million. Other important forms of support include protection against losses due to foreign exchange fluctuations and inflationary pressures, as well as the blending of public "concessional" funds with private export credits.

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Prospects

Paris considers its system of subsidized and guaranteed credits so firmly embedded in the structure of French trade with the Soviets that a major hardening of terms could paralyze French exports to the Soviets. Indeed, Paris is determined to improve its trade deficit with the Soviets and will almost certainly continue to look to government and commercial credits to achieve this end. The policy of officially supporting such credits may be conditioned somewhat by Mitterrand's harder attitude toward relations with the Soviets, but it will probably not be overridden. Another factor affecting Paris's decision is some growing disappointment among ministries on the subject, but again, the pro-trade forces appear in firm control.

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In response to Washington's negative view of Western governments granting easy guaranteed credits to the Soviet Union, Paris points out that the effect of credits on the Soviet economy is minimal, that the Soviet Union remains a good credit risk, and that France is contractually forbidden from immediately applying credit restrictions. In addition, although Paris looks with disfavor on the present practice of selling to the Soviets on credit and buying for cash, it believes that it must do so to remain competitive. As for burden-sharing among West European countries, the French believe that, given the wide differences in national export systems, such a prospect is unrealistic. The French would agree to ensure a better exchange of information on the matter of credits on a bilateral and possibly multilateral basis, and Paris has agreed to EC import restriction measures and to the EC's call to move the Soviets into the higher OECD category if all other OECD countries agree. At bottom, however,

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the French remain firm in their refusal to restrict exports to the Soviets or deny them credits for purchases of French goods. [redacted] 25X1

United Kingdom

Current Situation

High unemployment and new stress on using export growth as a way out of the recession make British agreement on even limited export controls unlikely. Although British trade with the Soviet Union accounts for less than 1 percent of the total, it is important to the depressed chemical industry; in addition, the Soviet Union could provide a potential market for British high technology goods. Much of the recent Soviet interest in British export goods has centered on oil and gas extraction, pipeline supplies, and engineering services. The government believes that reducing the subsidy element of offical guarantees would give low interest rate countries a large advantage in manufacturing trade. British firms, hard pressed by a profit squeeze and only partially regaining the losses in export competitiveness suffered over the last several years, will push the government to continue its current program. Spokesmen for the Export Credit Guarantee Department (ECGD), which administers London's export credit and official guarantee program, claim that credits are a normal part of doing business. The elimination of subsidies, they argue, would boost rates 4-5 percent and cripple their efforts. [redacted] 25X1

The ECGD is a separate government department responsible to the Secretary of State for Trade. All ECGD operations require the consent of the Treasury, but in practice only questions involving new credit policies, large amounts, or especially long terms are submitted to the Treasury. ECGD provides credit insurance to exporters and guarantees of repayment to private banks (either suppliers or buyers) for export credits. ECGD accepts 90 percent of the risk of the buyer's failure to pay and 90-100 percent of the political risk on comprehensive insurance. On bank guarantees, ECGD accepts 100 percent of the risk. [redacted] 25X1

The ECGD efforts to encourage Soviet purchases have been disappointing. For example, a \$2 billion, 5-year, project-related credit line ran out at yearend 1981 with only \$1.2 billion spent by the Soviets. Recently, however, several oil and gas projects -- under a 7.8-percent, 6-year ECGD line of credit -- were agreed. These have been committed and will be drawn as delivered in 1982-83. [redacted] 25X1

Prospects

In recent months British banks have adopted a more cautious attitude toward lending to the Bloc. The switch is based on economic considerations, with banks typically trying to shorten

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maturities and in some cases refusing new short-term loans and rollovers. In addition, in at least one case ECGD interest rates for a Soviet contract have been raised in response to a government directive to reduce credit allocations as part of budgetary cutbacks at all ministries. Although ECGD is basically operated as a commercial business, funding is voted annually by Parliament and recent losses on credit guarantees (primarily Iran) have left it short. 25X1

The United Kingdom is hesitant to rush into credit restrictions against the Bloc despite concerns about the level of Western credit exposure to the USSR. London believes that using influence to restrain Soviet activity is fundamental to Western security, but the government feels caught between its close ties to the United States and its membership in the EC, which it sees as moving in the opposite direction on this issue. It is especially concerned that the US approach would place a disproportionate share of the burden on the West Europeans and is skeptical of the impact credit restraints would have on Soviet military capabilities. In addition, London has voiced a general West European fear that the Soviets may try to retaliate, producing a series of escalating actions and eventual "economic war." The Thatcher government is actively seeking a US-EC compromise in which credit controls would be used only as part of a longer term program based on economic rather than political grounds. 25X1

Independent action by London will probably be limited to exchanges of information and a move to shift the Soviets to a higher credit classification based on economic grounds. Economic and political considerations make it imperative that the government oppose all but the most incremental of increases in interest charges. It may, however, consent to a compromise that would include fractional increases and larger differentials in categories, including some reclassification of Bloc and especially Soviet credits to higher rate categories. Britain does not share the US objective of eliminating subsidies. Moreover, any British move will seek to bridge the gaps between the US and the EC to take larger account of European economic considerations. The British are especially unhappy about the US push for trade sanctions on the pipeline because of their belief that Western Europe appears to be the major loser. 25X1

Italy

Current Situation

Traditional Italian enthusiasm for East-West trade is waning, at least in some quarters. Rome's inability to make up its mind on participation in the Siberian gas pipeline is indicative of the current ambivalence. Officials in Rome were thus relatively responsive to recent US overtures concerning limiting official subsidies and insurance on export credits involving the USSR, and intra-governmental discussions on a formal revision of existing policy are under way. 25X1

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The unsettled political climate in Italy has permitted partisan unhappiness with existing policy to come to the fore. The two largest political parties look favorably on East-West trade -- the Christian Democrats to please a large business constituency and the Communists for ideological reasons. With internal dissent plaguing these two parties, however, the anti-Soviet rhetoric of the Socialist and Social Democratic parties has taken on added significance. [redacted] 25X1

The disappointing evolution of Italian-Soviet trade also helps explain changing Italian attitudes. At the height of the cold war, large Italian firms were at the forefront of expanding East-West trade, and in the early 1960s Italy became one of the first Western countries to offer the USSR subsidized trade credits. During the heyday of detente in the 1970s, the relative attractiveness of Italian goods decreased as the Soviets began to enjoy better access to high-technology US, French, Japanese and West German goods. Sales to the USSR stagnated, dropping from 2.9 percent of total Italian exports in 1975 to 1.6 percent in 1980. This decline has affected all export industries, although the Soviet market remains very important for several Italian energy, automotive, and steel companies. [redacted] 25X1

To date the changing trade relationship has had only a marginal impact on export credit policy. Before the Afghanistan invasion, Rome periodically extended credit lines for Soviet purchases of Italian capital goods. Since 1980 new credits have been issued only on a case-by-case basis. Rome continues, however, to subsidize these credits. Mediocredito Centrale, a public institution, doles out subsidies equal to the difference between OECD Consensus rates and commercial financing costs. The 1980 budget gave Mediocredito $425 million to provide credit subsidies for exports to non-EC countries. Despite Rome's desire to promote Italian exports, the cost of providing these subsidies has become a contentious issue as fiscal problems have mounted. [redacted] 25X1

Prospects

While sentiment for limiting generous credit subsidies on exports to the USSR is growing, the Italian Government adamantly refuses to get out in front of its allies on this issue. On one level, this position stems from a desire to maintain export competitiveness. On another, in the current international climate Rome believes any action would be looked upon as equivalent to sanctions. Italian Communist Party leadership and influential members of the Italian-Soviet Friendship Society would view as unacceptable any measures resembling sanctions. Moreover, the Italian electorate considers sanctions ineffective at best and counterproductive at worst. In short, Rome will go along with a clear majority. Italian officials will remain willing to talk but will almost certainly not make a unilateral decision; nor will they promote a West European decision in line with US wishes. [redacted] 25X1

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Canada

Current Situation

Ottawa actively promotes trade with the Soviet Union, but Canadian exporters have been unsuccessful in penetrating Soviet markets other than grain. Total trade with the USSR accounts for only 1 percent of overall Canadian trade, but grain exports of close to $1 billion to the USSR constituted one fourth of Canada's positive trade balance in 1980, making the USSR a relatively important trading partner. 25X1

Canadian grain sales to the Soviet Union have thus far been in cash. The Canadian Wheat Board, however, is authorized to offer three-year financing, and other East Bloc countries already purchase wheat on credit. Given the deterioration of the Soviet financial position, it is unlikely that Canada would be willing to extend more than one-year loans if the Soviets were to ask for credit. 25X1

Unlike grain, exports of Canadian technology are made through long-term loans. These official export credits are provided by the Export Development Corporation (EDC), a commercially self-sustaining government corporation. The EDC first offered credits to the Soviet Union in 1970, but credit lines were not commonly used until the 1975 signing of a C$500 million line of credit. In most cases EDC loans to the USSR cover 85 percent of the value of the transaction. 25X1

The offical credit line was allowed to expire in 1979 to protest the Soviet invasion of Afghanistan. Since then, Ottawa has been reviewing proposals on a case-by-case basis; no new credit agreements have been signed. The EDC had approximately US$300 million worth of previously committed financing agreements with the USSR at the end of 1981. a25X1 US$600 million line of credit may soon be signed to finance exports of equipment for the Soviet Astrakhan gas project, for which Canadian firms are competing with French and West German companies. 25X1

Prospects

Trudeau is willing to discuss credit limitations in a multilateral setting and believes the Versailles Summit provides an excellent opportunity. While generally condemning Soviet activity in Poland, Trudeau views export credit limitations more as a reaction to the USSR's worsening financial position than to the Polish situation. Moreover, he would be more willing to go along with sanctions involving high technology goods than those involving grain embargo because the former would be much less damaging to Canada's trade. Trudeau believes Canada is bearing a disproportionate share of the burden of current East-West trade

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restrictions because Canada, according to Trudeau, more closely follows OECD guidelines on credits and interest rates than do others. He would like to see a more closely defined and enforced OECD consensus on credits to the Soviet Union. While generally supporting US proposals, Canada has some specific concerns:

- Ottawa would require West European backing of any US proposals before lending full support. This is one area where Trudeau likes to assert Canadian independence from the United States and makes a special effort not to follow US policy automatically.

- Trudeau would try to exempt the Astrakhan deal from any sanctions. Negotiations on the Astrakhan project have been underway since 1977 and he believes this sufficiently predates any current concerns. This is also Canada's first chance to exploit oil and gas technology markets in the USSR, and Ottawa is anxious for the deal to go through.

- Concerning proposals for more "transparency" in officially supported credits, Trudeau may have some difficulty in providing information on the EDC and on private credit agreements offered to the Soviet Union. Canada's Bank Act defines this information as confidential, and it would be very difficult for Trudeau to waive this right.

- Trudeau is presently quite concerned with the extraterritorial application of US policy on US-owned subsidiaries operating in Canada; this concern would mount if restrictions applied by the two countries differed or if Canada decided not to apply restrictions. [redacted] 25X1

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